

Subordinated Debt

Other Changes and Activities

Comptroller's Corporate Manual

**Washington, DC
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This booklet should be used together with other booklets of the *Comptroller's Corporate Manual*. Users of the "Subordinated Debt" booklet should refer to the "[General Policies and Procedures](#)" (GPP) booklet for a discussion of general filing instructions and procedures.

Background

National banks may issue subordinated debt. However, the subordinated debt must satisfy certain requirements capital to qualify as capital. Generally, a bank does not need the OCC's prior approval to issue or prepay subordinated debt (including payment pursuant to an acceleration clause or redemption prior to maturity), provided that the bank will remain an eligible bank after completing the transaction. However, prior OCC approval to issue or prepay subordinated debt is needed when:

- It is required by law (for example, 12 USC 1831o(h), which deals with severely undercapitalized banks).
- The OCC notifies the bank that prior approval is required.
- The bank is not an eligible bank either prior to or following a prepayment of subordinated debt.

A bank that is not required to obtain the OCC's prior approval must notify the OCC in writing within 10 days of issuing the subordinated debt that will count as Tier 2 or Tier 3 capital. No approval or notice is needed to issue or prepay subordinated debt that will not count as Tier 2 or Tier 3 capital, unless otherwise instructed by the OCC.

Sales of subordinated debt securities are subject to the securities offering disclosure requirements at 12 CFR 16.

Definitions

A **capital plan** is a proposal that describes the means and schedule by which a national bank will attain specified capital levels or ratios, including a plan to achieve minimum capital ratios, filed with the OCC under 12 CFR 3.7, or a capital restoration plan filed with the OCC under 12 USC 1831o and 12 CFR 6.5.

Tier 2 capital has the same meaning as in 12 CFR 3.2(d).

Tier 3 capital has the same meaning as in 12 CFR 3, Appendix B, section 2(d).

An **eligible bank** is a national bank that:

- Has a composite CAMELS rating of 1 or 2.
- Has an "outstanding" or "satisfactory" Community Reinvestment Act (CRA) rating. (This does not apply to an uninsured bank or branch or a special-purpose bank covered by 12 CFR 25.11(c)(3).)
- Is well capitalized as defined at 12 CFR 6.4(b)(1).
- Is not subject to a cease and desist order, consent order, formal written agreement, or prompt corrective action directive or, if subject to any such order, agreement or directive, is informed in writing by the OCC that the bank may be treated as an "eligible bank."

Key Policies

General

The OCC generally considers the issuance and prepayment of subordinated debt to be bank management decisions. When the OCC determines that its prior approval is required for a bank either to issue or prepay subordinated debt, approval may be withheld for a bank that:

- Fails to comply with a capital plan submitted to the OCC.
- Proposes a capital structure that the OCC considers inadequate.
- Exhibits conditions that threaten its safety and soundness.
- Fails to provide adequate information.

Criteria to Qualify as Capital

To be considered as Tier 2 capital, subordinated debt must meet the requirements of 12 CFR 3, Appendix A, section 2(b)(4), and comply with the "[OCC Guidelines for Subordinated Debt](#)" in the [Appendix](#) of this booklet. Subordinated debt eligible to be considered as Tier 2 capital must:

- Have an original weighted average maturity of at least five years.
- State on the instrument that it is not a deposit and is not insured by the Federal Deposit Insurance Corporation (FDIC).

- Be subordinated to the claims of depositors.
- Be defined as capital according to 12 CFR 3 or any other OCC rule, regulation, or policy.
- Be unsecured.
- Be ineligible as collateral for a loan made by the issuing bank.
- Provide that, once any scheduled payments of principal begin, all shall be made at least annually and the amount repaid each year shall be no less than in the prior year.
- Comply with securities offering disclosure requirements under the federal securities laws and OCC regulations, 12 CFR 16.

The total amount of subordinated debt that a bank may consider as Tier 2 capital is limited to 50 percent of the bank's Tier 1 capital. The OCC will require the debt to be subordinated to the obligations of *all* creditors, except those specifically designated as ranking on a parity with, or subordinated to, the note.

The amount of subordinated debt eligible for inclusion as Tier 2 capital is reduced by 20 percent of the original amount of the instrument (net of any redemptions) at the beginning of each of the last five years of the instrument's life. Thus, subordinated debt with less than one year to maturity is not included in Tier 2 capital.

In addition to Tier 2 capital, certain subordinated debt may qualify as Tier 3 capital. Tier 3 capital is limited in its use to satisfying the market risk capital requirements. To be considered as Tier 3 capital, the subordinated debt must meet the requirements of 12 CFR 3, Appendix B, section 2(d), which specify that the subordinated debt must:

- Be unsecured and fully paid up.
- Have an original maturity of at least two years.
- Include a provision that the subordinated debt is not redeemable before maturity without prior OCC approval.
- Include a lock-in clause precluding payment of either interest or principal (even at maturity), if the payment would cause the issuing bank's risk-based capital ratio to fall or remain below the minimum required under 12 CFR 3, Appendix A.

- Neither contain nor be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

Decision Criteria

To assess compliance with key policies and the criteria for qualifying capital for proposed issuances of subordinated debt instruments, the OCC will concentrate on provisions that:

- Accelerate the repayment date of the indebtedness.
- Restrict the bank from engaging in activities that would otherwise be permissible.
- Place note holders in a secured creditor status or give them priority over other creditors.

Legal Lending Limit and Other Statutory Limits

When a subordinated debt issuance or prepayment results in a change in capital for purposes of 12 USC 1831o and 12 CFR 6 (prompt corrective action), the OCC's authorization letter will confirm that the bank should calculate its lending limit and all other affected statutory limits on the basis of the resulting capital.

Reciprocal Holdings

A bank that purchases, exchanges, swaps, or otherwise agrees to hold the subordinated debt of another bank that holds any capital instruments of the purchasing bank, must deduct the amount it purchased from its own capital for both capital adequacy under 12 CFR 3 and the Consolidated Reports of Condition and Income (call reports). A national bank that issues subordinated debt must disclose in its application (if needed), or notice to the OCC, whether another bank that holds any capital instruments of the bank will or did purchase the subordinated debt. Subordinated debt of one bank received by another in satisfaction of debts previously contracted does not need to be deducted from the capital of the receiving bank provided that the holding bank has not held the debt for more than five years.

Summary of Process

Prior Approval Procedure

A bank that needs prior OCC approval to issue or prepay subordinated debt must apply to the appropriate OCC office. The application is considered

approved as of the 30th day after receipt by the OCC, unless the bank is specifically notified otherwise.

The subordinated debt should be issued within one year of approval. Once issued, the bank also must perform the procedures in the "Notice Only Procedures" section of this booklet.

A bank that is required to and receives OCC's prior approval to prepay subordinated debt also must notify the OCC within 10 days of completion of the transaction. This notice should include:

- The amount and date on which the reduction occurred.
- A statement that the change in the bank's capital structure complies with applicable laws and regulations.

Notice Only Procedure

Although an "eligible bank," as defined in the "Definitions" section of this booklet, is not required to obtain the OCC's prior approval before issuing subordinated debt, the bank must notify the OCC in writing within 10 days after the issuance of the subordinated debt for it to be considered as Tier 2 or Tier 3 capital. The notice must include:

- A description of the terms of the issuance.
- The date the funds were received and their amount.
- A copy of the final subordinated note format and agreement.
- A statement of whether the subordinated debt was issued to another bank that holds any capital instrument of the bank.
- A statement that the issuance complies with all relevant laws, regulations, and "[OCC Guidelines for Subordinated Debt](#)" in the [Appendix](#) of this booklet.

Once satisfied that the requirements have been met, the OCC will issue a letter to the bank acknowledging receipt of the notice.

Unless otherwise instructed by the OCC, a bank is not required to submit a notice for the prepayment of subordinated debt.

Shareholders' Approval

The OCC has eliminated its policy that required banks either to obtain shareholder approval for the issuance or prepayment of subordinated debt or amend the bank's Articles of Association to authorize the issuance or prepayment of such subordinated debt.

Securities Disclosure Requirements

When selling subordinated debt securities, a bank must comply with the registration requirements or otherwise qualify for an exemption under 12 CFR 16. Registration statements or other required documents should be filed with the OCC's Securities and Corporate Practices Division (SCP) in Washington, DC.

Application to Issue Subordinated Debt

Date

Licensing Manager, District
Comptroller of the Currency
Address
City, State, ZIP Code

Re: Issuance of Subordinated Debt

Dear Licensing Manager:

The (name of bank and charter number) wishes to issue the following subordinated debt as capital:

1. Purpose and description of the issue (amount of issue, maturity schedule, interest rate, convertible, nonconvertible, etc.).
2. A statement of whether the bank is subject to a capital plan or required to file a capital plan with the OCC and, if so, how the proposed issuance conforms to the capital plan.
3. A copy of the proposed subordinated note format and agreement.
4. A statement of whether the subordinated debt issue complies with all laws, regulations, and the "[OCC Guidelines for Subordinated Debt](#)" in the [Appendix](#) of this booklet. Identify unusual covenants.

(Applicants should identify any significant and restrictive covenants and any covenants that differ in substance from the sample subordinated note form (see [Appendix—Guidelines for Subordinated Debt](#)).)

The issuance will affect regulatory capital computations as shown in the enclosed Capital and Capital Ratio Schedule.

The issue will comply with the registration requirements or any available exemption under 12 CFR 16.

A filing fee of \$ (amount) is enclosed.

I request OCC action on this application no later than (date).

If you have questions, please contact (name) at (telephone number).

Sincerely,

—Signature—

Name and Title

Enclosure(s)

Capital plan (if applicable)

Copy of note form and agreement

Offering documents (if applicable)

Capital and Capital Ratio Schedule

Application to Prepay Subordinated Debt

Date

Licensing Manager, District
Comptroller of the Currency
Address
City, State, ZIP Code

Re: Prepayment of Subordinated Debt

Dear Licensing Manager:

The (name of bank and charter number) wishes to prepay the following subordinated debt. (Describe the issue and amount of the prepayment.)

The source of funds to prepay the debt will be (describe source).

The effects of the change on the equity capital accounts and capital ratios are detailed in an attached schedule (for assistance, see the "Optional Worksheet to Assist in the Risk-Based Capital Ratio Computation" included in the Consolidated Reports of Condition and Income).

The bank (is/is not) currently subject to a capital adequacy plan filed with the Comptroller of the Currency. (If applicable) the proposed change conforms to the plan by (provide explanation).

A filing fee of \$ (amount) is enclosed.

I request OCC action on this application no later than (date).

If you have questions, please contact (name) at (telephone number).

Sincerely,

) Signature)

Name and Title

Enclosure

Capital and Capital Ratio Schedule

Notice of Debt Issuance

Date

Licensing Manager, District
Comptroller of the Currency
Address
City, State, ZIP Code

Re: Notice of Issuance of Subordinated Debt
(If appropriate) CAIS Control Number

Dear Mr./Ms. (Name):

This will notify you that as of (date), (name of bank and charter number) issued subordinated debentures in the amount of \$ (amount), bearing an interest rate of (number) percent, and maturing (date). I certify that the funds have been fully paid in (in cash, and not in promissory notes or other evidences of debt)¹ as of (date). The issue complies with all regulatory and legal requirements and meets the conditions required by the Comptroller of the Currency (OCC) for such issues. A copy of the note form and agreement are enclosed.

(If applicable) The OCC declared effective the registration statement and any amendment on (date).

(If applicable) The subordinated debt (was/was not) sold to another bank. (If it was sold to another bank, include the name and location of the purchasing bank(s)). **(If the increase results in a change in the bank's capital category under 12 USC 1831o and 12 CFR 6)** The sale of subordinated debt resulted in the bank's capital category under 12 USC 1831o and 12 CFR 6 changing from (former capital category) to (new capital category). As a result, under 12 CFR 32.4(a)(2), the bank's legal lending limit and other statutory limits changed on (date).

Bank Representative

¹ This phrase should be eliminated when payment is made by other than cash or cash equivalent, i.e., property, or when the issuing bank loans or advances the funds to purchase the issuance to the purchasers.

Subscribed and sworn to before me this ____ day of _____, 19__.

State of _____)

County of _____)

(SEAL OF NOTARY)

Notary Public

If you have questions, please contact (name, address, city, state, ZIP Code) at
(telephone number).

Sincerely,

) Signature)

Name and Title

Enclosure(s)

Note Form and Agreement

Licensing Staff

1. Refers a bank that requests instructions to the "[General Policies and Procedures](#)" (GPP) booklet and this booklet of the *Comptroller's Corporate Manual*.

Prior Approval Requests

(Steps 2 through 22 apply only when a bank is required to obtain OCC approval prior to issuing or prepaying subordinated debt. Eligible banks, those not needing OCC prior approval, should go to step 23.)

Bank

2. Submits a complete application and filing fee to the licensing manager at the appropriate district office.

Review

Licensing Staff

3. Initiates and enters appropriate information into the Corporate Activities Information System (CAIS).
4. Notifies appropriate Assistant Deputy Comptroller/ examiner-in-charge (ADC/EIC) and/or portfolio manager of receipt of application.
5. Establishes the official file to maintain all original documents.
6. Forwards the filing fee and the deposit memorandum (Form 6043-01) to the Comptroller of the Currency, P.O. Box 73150, Chicago, Illinois 60673-7150. Retains a copy of the memorandum. Requests the filing fee if it was not received.
7. Within five business days of receipt of application:
 - Reviews the application and other relevant information about the bank to determine whether the application contains all information necessary to reach a decision.

- If yes, notifies the bank of receipt of the application and the target date for decision. Also, provides the CAIS Control Number.
 - If no, requests the missing information from the bank, specifying a response date. Also informs the bank whether the 30-day automatic approval date remains in effect.
 - Solicits comments from the appropriate portfolio manager or examiner-in-charge (EIC) and Assistant Deputy Comptroller (ADC) and from other OCC divisions, as appropriate, with preliminary responses required within 15 days after receipt.
 - Contacts the supervisory office staff to ascertain the status of the bank's capital plan if the bank is undercapitalized.
 - If a legal question is identified or a legal opinion was submitted with the application, forwards the relevant material to the Law Department, specifying that a preliminary response is required by within 15 days after receipt.
8. If at any time the application presents significant policy, legal, or supervisory issues, contacts BOS to decide:
- Whether the application should be filed with the Washington office, if broad issues are involved.
 - If specific issues should be carved out for Washington action, while the application continues to be processed in the appropriate district office.
 - When the filings should be forwarded to Washington.
9. Upon receipt of any comments or prior to the end of the 30-day automatic approval period, determines whether the application remains qualified for prior approval. If not, immediately notifies the bank, identifying the specific reason(s) for failing to grant prior approval.

Decision

Licensing Staff

10. Decides the application under delegated authority or forwards the official file to BOS for decision. If referred to BOS, goes to step 16.
11. Notifies the bank and, if appropriate, any interested parties.

12. Sends the bank the decision letter and a [Satisfaction Survey](#).
13. If the decision is either denial or conditional approval:
 - Notifies the appropriate ADC/EIC and/or portfolio manager of the decision by forwarding updated CAIS comments and, if warranted, any concerns.
 - Forwards a copy of the Confidential Memorandum, decision document, and transmittal letter to the Quality Assurance Coordinator.
14. Makes appropriate CAIS entries.
15. If the application is denied, goes to step 33.

BOS

16. Makes appropriate CAIS entries.
17. Reviews the file and all relevant information, solicits comments from other OCC divisions as appropriate, makes a recommendation, and forwards the official file to the appropriate official for decision.
18. Once decided, notifies the bank and district of the decision.
19. Sends the bank the decision letter and a [Satisfaction Survey](#), and notifies any interested parties (if applicable).
20. If the decision is either denial or conditional approval:
 - Notifies the appropriate ADC/EIC and/or portfolio manager of the decision by forwarding updated CAIS comments and, if warranted, any concerns.
 - Forwards a copy of the Confidential Memorandum, decision document, and transmittal letter to the Quality Assurance Coordinator.
21. Makes appropriate CAIS entries.
22. If approved or conditionally approved, returns the official file to the appropriate district office. If denied, goes to step 30.

Securities Review

Bank

23. Before commencing the sale of the securities, prepares and files with SCP a registration statement or any other documents required under 12 CFR 16.

Notification of Completed Changes

Bank

24. Notifies the licensing manager within 10 days of the transaction that the changes in subordinated debt occurred.

Authorizations

Licensing Staff

25. Reviews the bank's notification letter and documents to determine that all required information has been submitted. When prior approval was required, also reviews the official file to determine that all required actions occurred.
26. Notifies the bank by telephone and letter, if necessary, of any problems.
27. Prepares and mails letter to the bank to acknowledge receipt of the notice. Retains a copy in the official file. When prior approval is required, the approval letter will notify the bank whether the subordinated debt qualifies as Tier 2 or Tier 3 capital. The letter of final approval is authorization for subsequent reductions/conversions in capital, which correspond to the terms and maturity of the note instrument.
28. Notifies the appropriate supervisory office if the change results in a new capital category under 12 CFR 6—Prompt Corrective Action.
29. Makes appropriate CAIS entries.

Close Out

Licensing Manager/BOS

30. Reviews the official file for completeness and forwards it to Central Records.
31. Makes appropriate CAIS entries.

Subordinated Debt

References

Approval by Comptroller Regulation	12 CFR 5.47
Assessment Law	12 USC 55
Capital Definition Regulation	12 CFR 3
Capital Requirements and Minimum Ratios Law Regulation	12 USC 51 12 CFR 3
Filing Fees Regulation	12 CFR 5.5
Impairment Laws	12 USC 51b-1, 56
Legal Lending Limit Calculation Law Regulation	12 USC 84 12 CFR 32.4
Prompt Corrective Action Law Regulation	12 USC 1831o 12 CFR 6
Reduction Law	12 USC 59
Securities Offering Disclosures Rules Regulation	12 CFR 16
Subordinated Debt as Capital Regulation	12 CFR 5.47

Guidelines for Subordinated Debt

1. Mandatory Provisions

The following language, which has been drafted to comply with the requirements of applicable rules, regulations, and policies, must appear in every note, debenture, or note agreement.

- A. On the face of the note: "THIS OBLIGATION IS NOT A DEPOSIT AND IS NOT INSURED BY THE FEDERAL DEPOSIT INSURANCE CORPORATION."

Reference: 12 CFR 3.100(f)(1)(ii)

- B. On the face of the note: "THIS OBLIGATION IS SUBORDINATED TO CLAIMS OF DEPOSITORS, IS UNSECURED, AND IS INELIGIBLE AS COLLATERAL FOR A LOAN BY THE (NAME OF ISSUING BANK)." (Note: This clause may be combined with the required language set forth in (1)(A), above.)

Reference: 12 CFR 3.100 (f)(1)((I), (iv), and (v))

- C. A general subordination clause must be added that specifies the subordination of the note to obligations of the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and other general creditors. The clause must be in substantially the following form:

"The indebtedness of the bank evidenced by this note, including the principal and premium, if any, and interest shall be subordinate and junior in right of payment to its obligations to its depositors, its obligations under bankers' acceptances and letters of credit, and its obligations to its other creditors, including its obligations to the Federal Reserve Bank, Federal Deposit Insurance Corporation (FDIC), and any rights acquired by the FDIC as a result of loans made by the FDIC to the bank or the purchase or guarantee of any of its assets by the FDIC pursuant to the provisions of 12 USC 1823(c), (d) or (e), whether now outstanding or hereafter incurred. In the event of any insolvency, receivership, conservatorship, reorganization, readjustment of debt, marshaling of assets and liabilities or similar proceedings or any liquidation or winding up of or

relating to the bank, whether voluntary or involuntary, all such obligations shall be entitled to be paid in full before any payment shall be made on account of the principal of, or premium, if any, or interest, on the note. In the event of any such proceedings, after payment in full of all sums owing on such prior obligations, the holder, of the note, together with any obligations of the bank ranking on a parity with the note, shall be entitled to be paid from the remaining assets of the bank the unpaid principal thereof and any unpaid premium, if any, and interest before any payment or other distribution, whether in cash, property, or otherwise, shall be made on account of any capital stock or any obligations of the bank ranking junior to the notes.

Nothing herein shall impair the obligation of the bank, which is absolute and unconditional, to pay the principal of and any premium and interest on the note according to its terms."

- D. To clarify for the purchaser the Comptroller's flexibility in insolvency cases, the following paragraph (or one which is substantially equivalent) must be included:

"Notwithstanding any other provisions of this note, including specifically those set forth in the sections relating to subordination, events of default and covenants of the bank, it is expressly understood and agreed that the Office of the Comptroller of the Currency (OCC) or any receiver or conservator of the bank appointed by the OCC shall have the right in the performance of his legal duties, and as part of liquidation designed to protect or further the continued existence of the bank or the rights of any parties or agencies with an interest in, or claim against, the bank or its assets, to transfer or direct the transfer of the obligations of this note to any bank or bank holding company selected by such official which shall expressly assume the obligation of the due and punctual payment of the unpaid principal, and interest and premium, if any, on this note and the due and punctual performance of all covenants and conditions; and the completion of such transfer and assumption shall serve to supersede and void any default, acceleration or subordination which may have occurred, or which may occur due or related to such transaction, plan, transfer or assumption, pursuant to the provisions of this note, and shall serve to return the holder to the same position, other than for substitution of the obligor, it would have occupied had no default, acceleration or subordination occurred; except that any interest and principal previously due, other than by reason of acceleration, and not

paid shall, in the absence of a contrary agreement by the holder of this note, be deemed to be immediately due and payable as of the date of such transfer and assumption, together with the interest from its original due date at the rate provided for herein."

- E. Issues of subordinated notes and debentures, except mandatory convertible debt, must have an original weighted average maturity of at least five years.

Reference: 12 CFR 3.100(f)(1)

- F. Mandatory convertible debt must require without qualification that the issuer exchange either common or perpetual preferred stock for such instruments by a date at or before the maturity of the instrument. The maturity must be 12 years or less.

Reference: 12 CFR 3.100(e)(5)

2. OCC Policy on Other Provisions

In reviewing the purchase agreement and note, the Licensing staff must allow the bank flexibility in conducting its daily affairs. The following discussion lists some areas that require the reviewer's attention.

A. Representations and Warranties

Some agreements contain warranties stating that the bank is a duly organized banking association, that there has been no material adverse change in its condition since the date of the agreement and is not in default on any agreement or in violation of its charter or bylaws.

Special attention should be given to a warranty or representation of the bank that it is a national banking association. This is because, technically speaking, the bank has not given itself the legal option of converting to a state bank without violating the warranty or representation, and hence, the agreement. The reviewer should ensure that any representations or warranties of the bank's corporate status are worded flexibly to avoid the operation of any default clause should a change in corporate status occur.

B. Subordination Provision

The subordination provision is the heart of the note. Two questions have arisen about this provision:

1. May a note be secured by the bank's assets via a sinking fund arrangement or otherwise? The answer is NO. If the notes are secured, the proceeds from the sale of the assets securing the loan, in the event of insolvency, would be applied to the obligations of the purchaser-noteholder. The notes would clearly be, in effect, senior in right of payment to other creditors.
2. Must the note be subordinate only to the claims of depositors or, in addition, be subordinate to the obligations of the Federal Reserve, FDIC, and other creditors? Because these notes are considered as capital, the OCC will require that they be subordinate to the obligations of all creditors, *except* those specifically designated as ranking on a parity with, or subordinated to, the note. By their nature, subordinated notes must be subordinate to all but equity accounts.

Every subordinated note must include the model subordination clause (or substantially similar language) set forth in the Sample Subordinated Note found later in this Appendix.

C. Acceleration Clauses

Formerly the OCC required that no payment due to acceleration could be paid without its prior approval. This requirement had to be disclosed to potential buyers of the subordinated debt. Effective with the July 1, 1995 changes to 12 CFR 5, prior OCC approval of accelerated payments is no longer required except when the subordinated debt is intended to qualify as Tier 3 capital. A bank that is healthy when issuing subordinated debt, however, may deteriorate in condition, and the OCC may, under the authority in 12 CFR 5, require that any prepayment of outstanding subordinated debt be made only with the OCC's prior approval.

Consequently, banks issuing subordinated debt that either have been informed that prior approval of the issuance or prepayment (including payments under acceleration clauses) of the subordinated debt requires prior OCC approval or intend the subordinated debt to qualify as Tier 3 capital must disclose this on the subordinated note. Other banks issuing subordinated debt must disclose in the note that the OCC reserves the authority, pursuant to 12 CFR 5, to require that prepayments (including any to be made under an acceleration clause) receive OCC prior approval before being made.

D. Affirmative Covenants

In an affirmative covenant, a bank promises to perform certain actions. Its failure to do so may constitute an event of default. Generally, a bank may enter into any type of agreement as long as it does not violate a law, regulation, or OCC policy. The reviewer should closely examine those covenants, which may restrict the bank's operations abnormally or require it to violate a law, regulation, or OCC policy. Some areas of concern include:

1. *Availability of Financial Statements and Correspondence*

The OCC will not object to a clause permitting the purchaser to inspect the books and correspondence of the bank. However, the bank should never allow confidential correspondence or reports of supervisory activity (or parts thereof) be made available or otherwise disclosed, unless directed by the OCC pursuant to 12 CFR 4, Subpart C.

Financial statements may not be furnished prior to the date that they would be filed with the OCC. Quarterly statements should be provided within 45 days after the end of the quarter and yearly ones, within 90 days after the end of the year.

2. *Disclosure of Classified Assets*

Disclosure of any information contained in a bank's report of examination would violate confidentiality restrictions under which the report is provided to the bank. The bank, however, may agree to disclose any information derived from its system of internal audits or otherwise and may disclose information that is publicly available, such as the allowance for possible loan losses.

3. *Compensating Balances*

The OCC discourages the use of compensating balances, because of the potential for placing the note purchaser in a secured position. These arrangements are rare, but if compensating balances exist they should be scrutinized closely to prevent any possible creation of a special fund earmarked for the repayment of the note, which would elevate the purchaser to a secured position. The right to offset the debt against any compensating balance is strictly prohibited.

Compensating balances are discouraged for several reasons. The cost of funds is no longer clear cut. The cost of

maintaining a balance would not be tax deductible, and the bank loses the use of funds indicated on its balance sheet. The practice of selling subordinated notes to correspondent banks clouds the issue, as it may be difficult to differentiate between the normal or required correspondent balance.

E. Negative Covenants

In a negative covenant, a bank promises to refrain from performing certain actions, or agrees that the occurrence of a certain event will give rise to default. Since purchasers are intent on obtaining a maximum degree of security, they often attempt to restrict the bank from engaging in certain risky activities. The OCC discourages any provisions that unreasonably impair the bank's flexibility in conducting its operations. It also disapproves of any undue interference with management that could result in unsafe or unsound banking practices.

1. Maintenance Ratios as an Event of Default

Some purchasers have proposed negative covenants that would require the bank to maintain certain minimum amounts in its capital accounts, or minimum capital to assets, liquidity, or loan ratios. These types of maintenance ratios do not provide the notes with a sufficient degree of permanence or stability. If this arrangement were accepted, notes would be subject to acceleration if the bank experienced short-term financial difficulties beyond its control.

Representations by the bank that its capital ratios are at specific levels as of the date of the note are acceptable, provided that they do not, directly or indirectly, constitute maintenance ratios.

2. Restrictions on Additional Debt

Any proposal to restrict the issuance of additional debt should be scrutinized on a case-by-case basis. Such limits may unduly restrict the bank's ability to raise additional capital through the issuance of subordinated debt.

On occasion, a purchaser has proposed that any notes issued by the bank in the future be junior in right of payment to the current issue. This restriction is not allowed. The bank should be capable of issuing notes that will rank on a parity with the current issue. The rationale is that if future issues were

required to rank junior to the present issue, the bank might find it difficult to sell notes to maintain an adequate capital base.

3. *Change of Control or Merger*

Some purchasers have insisted on provisions that would allow a change in control or merger to constitute a default. The OCC does not allow the sale of stock at the direction of the Comptroller, which results in a change in control, to constitute a default. In practice, the OCC requires the purchaser of the bank to assume the obligation on the subordinated debt. Therefore, the note holder would be adequately protected.

OCC policy also provides that voluntary or involuntary mergers should be allowed without triggering a default, if the resulting institution: (a) is a commercial bank; (b) assumes the due and punctual performance of all conditions of the note and agreement; and, (c) is not in default of the various covenants. The OCC will not permit a provision that requires the bank to obtain the purchaser's or holder's approval prior to entering into a merger agreement.

4. *Subsidiaries*

Questions have been raised as to whether an action (e.g., a default) by a subsidiary may trigger an acceleration of the note. The answer is NO. The OCC does not allow a default by a subsidiary to constitute a default by the bank, absent a separate agreement between the subsidiary and the purchasers that is also to be reviewed and approved by the OCC.

5. *Restrictions on Dividends*

The OCC does not permit a purchaser to restrict the payment of cash dividends because such dividend restrictions may be construed as the creation of a sinking fund to protect an unsecured creditor of the bank.

6. *Defaults*

The holder of any subordinated note may, at its option, declare the note to be due and payable when certain covenants have been violated. The following are some events of default:

- a. Nonpayment of the interest and/or principal when due after a 15-day grace period.

- b. Nonpayment of borrowed money or failure to satisfy a final judgment if either the nonpayment of borrowed money or the failure to satisfy a final judgement is in excess of 5 percent of the bank's capital or \$250,000, whichever is greater.
- c. Admission by the bank in writing of its inability to pay its debts or the filing of a petition under applicable insolvency or reorganization statutes.
- d. Consent to or appointment of a conservator or liquidator in any insolvency, readjustment of debts, or marshaling of assets.
- e. Default in performance or observance of certain other covenants after a prescribed grace period has expired.

When a default has occurred and is continuing, the registered owner of any note may, at his/her discretion, by notice in writing to the bank, declare the principal amount and any accrued interest on any note in default to be immediately due and payable. A declaration by the registered owner or owners of at least 25 percent in principal amount of the notes outstanding will cause the unpaid principal of all the notes outstanding together with the interest accrued to become due and payable.

As a matter of policy, the OCC prefers events of default that provide for a reasonable period to "cure" the default, if possible.

F. Transfer at OCC Direction

The OCC also requires the insertion of certain (or substantially similar) language to permit a bank to merge or follow any plan of reorganization or liquidation designed to protect or further the continued existence of the bank. This language (reproduced in the Sample Subordinated Note found later in this Appendix) supersedes and voids any defaults that would have resulted from the breach of the various covenants. It specifically authorizes the OCC (or its appointed agent) to transfer the note to any banking entity that agrees to assume its obligations of the note.

G. Contemporaneous Loan Agreements

The OCC has found, on occasion, that a bank holding company or other note purchaser will "fund" the injection of subordinated debt into a national bank by a contemporaneous loan agreement with a

third-party lender. The terms and conditions of these loan agreements often, by their language, place significant, and unacceptable, restrictions on the operations of the bank raising subordinated debt. Accordingly, it is important to determine, in all instances, whether such a third-party loan agreement exists and, if it does, to review that agreement for compliance with the requirements and policies discussed here.

H. Novel or Extraordinary Provisions

These discussions will address most of the questions encountered in a routine review. However, sometimes, novel and untested proposals will be presented. Such proposals and those that raise policy concerns should be referred to the OCC's Bank Supervision Policy Department for review and final disposition.

Sample Subordinated Note

THIS OBLIGATION IS NOT A DEPOSIT AND IS NOT INSURED BY THE FEDERAL DEPOSIT INSURANCE CORPORATION. THIS OBLIGATION IS SUBORDINATED TO THE CLAIMS OF DEPOSITORS, IS INELIGIBLE AS COLLATERAL FOR A LOAN BY THE BANK, AND IS NOT SECURED.

\$_____

Date: _____

NOTE: The first two paragraphs apply to a subordinated note. Paragraphs three through six apply to a mandatory convertible note. The remaining paragraphs apply to both a subordinated note and a mandatory convertible note.

[Subordinated Note]

_____, (bank name), a national banking association, promises to pay to the order of _____ (the "purchaser"), at the purchaser's offices in _____ in lawful money of the United States of America, the principal amount of \$_____, together with interest on the part of the principal amount from time to time remaining unpaid from this date until such principal is paid at the rate of ____ percent per annum.

The entire unpaid principal of this note and any accrued interest then unpaid shall be due and payable on or before _____. The interest on this note shall be due and payable semi-annually as it accrues on the first day of each _____ and _____ until this note is paid in full, commencing on the first such day next succeeding this date. The bank shall have the right and privilege of prepaying all or any part of this note at any time without notice or penalty, subject to OCC approval, and all payments on this note shall be applied first to accrued interest and the balance, if any, to principal.

[Mandatory Convertible Note]

_____, (bank name), a national banking association, promises to pay to the order of _____ (the "purchaser") the principal amount of \$_____ on _____, through the exchange of capital stock with a (method of determining value) value equal to the principal sum.

The bank promises to pay to the order of _____ (the "purchaser") at the purchaser's offices in _____ in lawful money of the United States of America, interest on the principal amount of \$_____, at the rate of _____

_____ percent per annum from _____ until maturity. Interest is due and payable semi-annually as it accrues on the last business day of _____ and _____ in each year commencing _____ and at maturity.

The bank represents and warrants that all capital stock issued in exchange for the note will upon issuance be duly and validly authorized and issued and fully paid and (except as provided in 12 USC 55) nonassessable.

No fractional shares of capital stock will be issued in exchange for the note. In lieu of issuing any fractional shares, the bank shall pay a cash adjustment for such fraction in an amount equal to the same fraction of the (method of determining value) value of one share of capital stock.

[Subordinated Note/Mandatory Convertible Note]

The indebtedness of the bank evidenced by this note, including the principal and premium, if any, and interest shall be subordinate and junior in right of payment to its obligations to its depositors, its obligations under bankers' acceptances and letters of credit, and its obligations to its other creditors, including its obligations to the Federal Reserve Bank, Federal Deposit Insurance Corporation (FDIC), and any rights acquired by the FDIC as a result of loans made by the FDIC to the bank or the purchase or guarantee of any of its assets by the FDIC pursuant to the provisions of 12 USC 1823(c), (d) or (e), whether now outstanding or hereafter incurred. In the event of any insolvency, receivership, conservatorship, reorganization, readjustment of debt, marshaling of assets and liabilities or similar proceedings or any liquidation or winding up of or relating to the bank, whether voluntary or involuntary, all such obligations shall be entitled to be paid in full before any payment shall be made on account of the principal of, or premium, if any, or interest, on the note. In the event of any such proceedings, after payment in full of all sums owing on such prior obligations, the holder, of the note, together with any obligations of the bank ranking on a parity with the note, shall be entitled to be paid from the remaining assets of the bank the unpaid principal thereof and any unpaid premium, if any, and interest before any payment or other distribution, whether in cash, property, or otherwise, shall be made on account of any capital stock or any obligations of the bank ranking junior to the notes. Nothing herein shall impair the obligation of the bank, which is absolute and unconditional, to pay the principal of and any premium and interest on the note according to its terms.

This note shall become immediately due and payable, at the option of the holder, without presentment or demand or any notice to the bank or any other person obligated, (i) upon default in the payment of any of the principal or interest, for a period of 15 days after such payment is due; (ii) upon default (a) in the payment of any of the principal of or interest on any other indebtedness of the bank for borrowed money owing from the bank to the purchaser, or (b) in the payment of any other material indebtedness for

borrowed money and, in either event, the continuance of such default beyond any period of grace provided for in the instrument or instruments evidencing such indebtedness.

The bank waives demand, presentment for payment, notice of nonpayment, notice of protest, and all other notices.

Notwithstanding any other provisions of this note, including specifically those set forth in the sections relating to subordination, events of default and covenants of the bank, it is expressly understood and agreed that the Office of the Comptroller of the Currency (OCC) or any receiver or conservator of the bank appointed by the OCC shall have the right in the performance of his legal duties, and as part of liquidation designed to protect or further the continued existence of the bank or the rights of any parties or agencies with an interest in, or claim against, the bank or its assets, to transfer or direct the transfer of the obligations of this note to any bank or bank holding company selected by such official which shall expressly assume the obligation of the due and punctual payment of the unpaid principal, and interest and premium, if any, on this note and the due and punctual performance of all covenants and conditions; and the completion of such transfer and assumption shall serve to supersede and void any default, acceleration or subordination which may have occurred, or which may occur due or related to such transaction, plan, transfer or assumption, pursuant to the provisions of this note, and shall serve to return the holder to the same position, other than for substitution of the obligor, it would have occupied had no default, acceleration or subordination occurred; except that any interest and principal previously due, other than by reason of acceleration, and not paid shall, in the absence of a contrary agreement by the holder of this note, be deemed to be immediately due and payable as of the date of such transfer and assumption, together with the interest from its original due date at the rate provided for herein.

By: _____

Name: _____

Title: _____

Subordinated Debt Quick Reference Chart

For specific requirements see applicable laws and regulations and relevant sections in this booklet.

	<i>Prior OCC Approval Required</i>	<i>Notification and Certification Only</i>	<i>Expedited Review</i>	<i>Laws</i>	<i>Regulations</i>
<i>To issue subordinated debt¹</i>	no	yes (If Tier 2 or Tier 3 capital) ²	yes	12 USC 93a 12 USC 57	12 CFR 5.47
<i>To repay subordinated debt according to maturity</i>	no	yes	yes	12 USC 93a 12 USC 59	12 CFR 5.47
<i>To prepay subordinated debt</i>	yes ³	n/a	no	12 USC 93a 12 USC 59	12 CFR 5.47 12 CFR 3, Appendix B, Section 2(d)
<i>OCC previously notified the bank that prior approval is required</i>	yes	n/a	no	15 USC 57a 15 USC 77h-1	12 CFR 5.47
<i>Prior approval required by law</i>	yes	n/a	yes	12 USC 51b-1 12 USC 56	12 CFR 5.47

¹12 CFR 5.47(l) — A national bank shall comply with the Securities Offering Disclosure Rules in 12 CFR 16 when issuing subordinated debt even if the bank is not required to obtain prior approval to issue subordinated debt.

²12 CFR 5.47(e)(1) — A national bank's subordinated debt qualifies as Tier 2 capital if the subordinated debt meets the requirements in 12 CFR 3, section 2(b)(4) of Appendix A, and complies with the OCC Guidelines for Subordinated Debt in this booklet.

³Applicable if (a) the bank is not well capitalized regardless of whether the subordinated debt is intended to count as capital; (b) the subordinated debt is intended to count as Tier 2 capital and the bank is not well capitalized or has been previously notified by the OCC that prior approval is required; or (c) the subordinated debt is intended to count as Tier 3 capital.